FRANCHISE TAX BOARD
Fiscal Year 2005/06

Budget Change Proposal	**BCP No. 3**
Tax Gap Enforcement Provisions	**Date: November 1, 2004**

A. Nature of Request

This proposal requests funding of $8.615 million and 99.2 PYs (106.5 positions) to address California's estimated $6.5 billion income tax gap. The positions are two-year limited term to insure that workload demands justify on-going permanent status.

The income tax gap consists of several categories of tax noncompliance. Therefore, this proposal includes a group of proposed initiatives intended to attack the problem in a comprehensive manner by increasing enforcement of existing statutes, by undertaking new deterrent measures and by creating public awareness of the consequences of tax-related cheating. The following measures work most effectively as a group, rather than as separate and disconnected proposals:

1. Enhanced detection of tax preparers filing fraudulent returns
2. Audit staff augmentation
3. Additional information sources to identify nonfilers
4. Informant reward program
5. Underground economy criminal investigations

Undertaking these initiatives in FY 2005/06, following the implementation of a tax amnesty program for FY 2004/05, will enable Franchise Tax Board (FTB) to begin attacking the growing tax gap compliance problem beyond current budgeted levels. This will generate revenue in the short term as well as enhance overall voluntary tax compliance in the long term.

FTB estimates these tax gap enforcement efforts will produce revenue benefits of $34 million in FY 2005/06, increasing to $44 million in FY 2006/07, and nearly $46 million in FY 2007/08 (see Attachment I).

B. Background

The tax gap is defined as the difference between what taxpayers owe and what they voluntarily pay. California's income tax gap has grown over the years from an estimated $2 billion dollars annually in the 1980's to an estimated $6.5 billion today. This estimate is based on the Internal Revenue Service (IRS) calculations of the federal tax gap, and it does not include those revenues lost to abusive tax shelters or unknown illegal activities. In addition, the estimate does not include taxes administered by the Employment Development Department or the Board of Equalization.

Revenue agencies historically have addressed tax cheating, nonfiling and erroneous filing through a variety of program activities funded according to a "return-on-investment" methodology. For example, a $1:$5 cost-to-benefit ratio (CBR) traditionally has been the yardstick to use when considering the expansion of FTB's existing compliance programs. While the CBR approach correctly attributes short-term revenue associated with a specific business activity, such as auditing tax returns, it does not reflect the longer term benefits that result from undertaking a "holistic" set of compliance activities such as the programs described in this BCP. These benefits consist of increased voluntary compliance on the part of individual and business entity taxpayers who will choose to file accurately and pay what they owe in the future, rather than join the ranks of those who fail to file and pay or those who misreport income and claim excessive deductions or credits.

The following factors also should be considered in evaluating the intended fiscal and policy outcomes intended by BCP 3:

- A CBR approach only takes into consideration revenue associated with a specific business activity, such as auditing tax returns, over a relatively short-term period.
- The CBR does not reflect longer-term benefits that result from undertaking a "holistic" set of compliance activities such as the programs described in our BCP.
- The CBR approach does not measure benefits associated with increased voluntary compliance on the part of individual and business entity taxpayers who will choose to file accurately and pay what they owe in the future, rather than join the ranks of those who fail to file and pay or those who misreport income and claim excessive deductions or credits.

FTB likely would never discover unknown and currently unidentified but significant revenue owed to the State of California unless it undertakes new tax gap programs such as those proposed in BCP 3. The Department's Economic and Statistical Research staff has estimated that voluntary tax compliance and current enforcement-related compliance programs capture approximately 86% of all income tax revenue owed to the State of California. The remaining 14% of uncollected revenue falls into the $6.5 billion income tax gap. For every one percent increase in voluntary and enforcement-related compliance that results from the cumulative impact of undertaking new tax gap measures proposed by BCP 3, the State will realize approximately $500 million in revenue that otherwise is lost.

Historically, FTB has not attempted to estimate revenue associated with increases in voluntary compliance resulting from enforcement measures. Such measurement is difficult to "baseline." However, FTB's Economic and Statistical Research staff was able to estimate revenue for one measure proposed by BCP 3, use of escrow/title company information to identify payments made to real estate brokers. Enforcement revenue for this information source is estimated to result in $1.3 million (when fully implemented) through the detection of nonfilers. Revenue attributed to a resulting increase in voluntary compliance as a result of using the broker information is estimated to be at least $10 million.

IRS data shows that taxpayers voluntarily pay about 85% of the income taxes they owe. As this percentage applies to California for FY 2004/05, it is estimated that California income tax receipts collected through voluntary means will total $45.6 billion. Apart from the one-time Voluntary Compliance Initiative that allowed taxpayers who participated in abusive tax shelters to come forward in 2004/05 and pay back taxes, about $2 billion will be collected through FTB's traditional tax compliance programs.

Voluntary compliance varies based on source of income, particularly for those who earn wages compared to those who are self-employed. IRS statistics show that:

- Wage earners report nearly 99% of their wages.
- Self employed individuals, who operate formally, report 68% of their business income.
- “Informal suppliers,” self-employed individuals operating informally on a cash basis, report just 19% of such income on their tax returns.

Implementing the tax gap enforcement measures described in this BCP will produce new revenue and will accelerate revenue. But more importantly, these measures will cause taxpayer behavioral changes in favor of self-compliance over the long term and the state’s tax base will increase. New and accelerated revenue estimates have been developed for each of the component measures in this proposal.

Changing the attitudes and behavior of taxpayers who now cheat or are considering cheating, and reassuring honest taxpayers that they are doing the right thing, requires that we enforce the tax laws vigorously and that we tell taxpayers that they will get caught if they cheat. Enforcement efforts lose their effectiveness if only a few taxpayers know that FTB has stepped-up its programs. Therefore, closely tied to this proposal, is an education and publicity element. Informing the public of these new efforts through the media will help the provisions have a much broader impact on taxpayer behavior than the result of a single enforcement action on an individual taxpayer.

Publicity and education will:

- Encourage future self-compliance by taxpayers who are currently circumventing their tax obligations.
- Deter others who are considering noncompliance
- Reassure compliant taxpayers that paying their fair share is the right thing to do.

Special attention has been made in developing these proposals to minimize new burdens placed on employers and other businesses involved in providing information to the government or taking other actions required to comply with tax laws. Nevertheless, FTB recognizes that additional information reporting burdens will be imposed on a few industry groups for the measure that calls for more income reporting to identify nonfilers.

Proposed Tax Gap Enforcement Measures

1. Enhanced Detection of Tax Preparers Filing Fraudulent Returns

Resource Need: $2.6 million / 34.9 PYs (36.5 positions)
*Revenue Benefits Revised: FY 2005/06 $13 million and $14.5 million beginning in FY 2006/07

This proposal will expand FTB’s program to identify tax preparers who file fraudulent tax returns claiming fictitious credits to claim refunds. These preparers typically file returns for many taxpayers (some prepare hundreds of fraudulent returns), each claiming a fraudulent credit. For FY 2003/04 FTB prevented $2.5 million in fraudulent refunds from being issued. An additional $1.2 million remains to be collected from refunds issued prior to detection. The list of potentially fraudulent preparers examined and verified during the year was accomplished by temporarily shifting resources. This resulted in backlogs in other return processing areas.

FTB will enforce this measure through both audit and filing program activities. Each area identifies different types of tax preparers for either audit or fraud recovery.

- The audit program will identify preparers understating their clients' tax liabilities by using methods of sufficient complexity requiring FTB to perform manual audits. FTB auditors will assess the unreported taxes to taxpayers as well as assess penalties against tax preparers.
- Filing program fraud prevention and detection (FPD) staff will use fraud modeling to detect fraudulent tax preparers. Generally, these tax preparers claim invalid deductions or credits for their clients. The majority of these cases are caught during initial processing of the return.

Assessment of Penalties

The audit program will assess penalties on preparers found to understate tax liabilities. Understatement includes determination that a preparer has adopted a position for which there was not a realistic possibility of being sustained on its merits; willful attempt to understate; and reckless or intentional disregard of rules or regulations. The penalty is either $250 per return if the understatement is due to unrealistic positions of the preparer or $1,000 per return if the understatement is due to willful or reckless conduct by the preparer. Once such tax preparers are identified, audit program staff will obtain client information using the tax preparers' identification number (PTIN) to scope and detect errors. Additionally, auditors will coordinate with FPD staff to assess penalties on preparers identified through the fraud recovery process. The revenue from such penalties is detailed below under the Fraud Detection discussion. Assessing a penalty on tax preparers for each incorrect tax return will encourage the tax preparer to change behavior and comply in the future.

Audit Program Activities

After identifying tax preparers who file false or incorrect returns, audit staff will actively conduct audits and issue assessments on the clients of the preparers. Note that these preparers and associated issues are different from those identified through the FPD fraud recovery process. The audit program activities proposed by BCP 3 will extend significantly beyond existing activities in which the IRS currently pursues abusive return preparers and provides information to FTB. The new program will focus on the unethical practices of preparers who create substantially understated tax liabilities. The audits of these clients will be conducted using existing audit CBR criteria. The end result is that the increased audit activity not only will reduce preparer fraud but also will act as a strong deterrent for preparers' clients who will be subject to audit.

Fraud Detection Activities

FTB's FPD staff use a variety of methods to identify taxpayers and tax preparers who intentionally alter tax liabilities, resulting in fraudulent refunds to taxpayers and prevent the payment of those refunds. Since the passage of AB 480, which created the refundable Child and Dependent Care Credit (CDC), FPD staff has focused on methods to effectively discover and deter the expected fraudulent claims for this credit.

In the second half of 2003, FPD staff employed a new modeling process to identify Tax Year 2002 abuses noted for electronically filed returns. Staff focused on 79 tax preparers who subsequently e-filed questionable 2003 returns claiming CDC for their clients. FPD staff verified the returns of these 79 tax preparers utilizing the 15.2 PYs allocated as a result of AB 480 legislation. This effort prevented $2.5 million in fraudulent refunds from being issued and an additional $1.2 million is in the process of being collected for FY 2003/04. Using the same process for Tax Year 2003 returns, FPD staff identified an additional 268 highly questionable preparers who submitted suspicious CDC claims. Thus far for FY 2004/05, FPD staff has been able to identify 30 of these preparers, resulting in the prevention of an anticipated $2 million in fraudulent CDC refunds. Due to resource limitations, FPD staff is unable to verify the returns of the remaining 238 questionable tax preparers.

In a quick review of Tax Year 2003 paper tax returns, FPD staff identified a similar list of 26 potentially fraudulent preparers. These cases will be worked in FY 2004/05 to provide a balance between e-file and paper filing. The positions authorized by AB 480 will, therefore, be split between the e-file and paper claims. FPD staff expects to discover similar levels of fraud on the paper side.

Potential to Increase Compliance and Help Close the Tax Gap

There are significantly more questionable tax preparers whose returns need to be verified to discourage the abuses described above, especially those related to fraudulent claims of refundable credits. The IRS's experience with the refundable Earned Income Credit (EIC) reveals that even with a fraud detection program in place, the abuse in refundable credit claims continues each year. While some fraud is stopped each year, new schemes crop up to replace those detected.

The IRS estimates that 30% of federal EIC claims are fraudulent, leading to refunds between $8.5 billion and $9.9 billion annually. BCP 3 will enable FTB to identify preparers who file an estimated 56,000 returns claiming CDC each year. This represents approximately eight percent of all CDC claims per year. Without addressing this abuse, California is likely to experience an increase as has occurred at the federal level.

BCP 3 also will enable FPD staff to refer abusive preparers to the audit program for assessment of the tax preparer penalty. The revenue associated with assessing these penalties will result in an estimated $370,000 annually (discounted for actual collections). Currently, FTB pursues the most egregiously fraudulent tax preparers but lacks resources to pursue all preparers detected. Imposing a penalty will provide a strong deterrent to tax preparers considering such fraudulent practices. On average, it is estimated that each tax preparer who is deterred will reduce by $150,000 annually, the client claims for fraudulent tax refunds.

Value of Publicity:
Enforcement efforts lose their effectiveness if only a single taxpayer knows of an enforcement action. Closely tied to this provision is an education and publicity element.

Informing the public of this effort through the media will have a much broader impact on taxpayer behavior than the result of a single enforcement action on an individual taxpayer.

2. Audit Staff Augmentation
Resource Need: $2.5 million / 29.4 PYs (31 positions)
Revenue Benefit: FY 2005/06 $8.7 million and $13 million beginning in FY 2006/07

BCP 3 proposes an augmentation of audit staff to address workloads below the typical $1:$5 CBR. This includes review of claims filed by taxpayers who believe they have overpaid their taxes. FTB estimates that audit of these would protect (deny) existing self-assessed tax of $1.2 million annually. Current staff resources are not sufficient to address this workload.

In addition, by adding auditor positions to FTB's workforce, the audit program will generate additional revenue at the $1:$4 CBR margin and will have flexibility to redirect audit staff to workloads above the $1:$5 level as they are discovered. Staffing to work the following workloads will generate significant additional revenue:

- Automated Audit will generate $1.4 million in FY 2005/06 and $2.2 million in FY 2006/07.
- Professional Audits will generate $5.3 million in FY 2005/06 and $8.7 million beginning in FY 2006/07.
- Unreported Income Detection will generate $2.1 million beginning in FY 2005/06.

Note that the largest segment of the $6.5 billion tax gap pertains to underreporting of income. The estimated revenue identified above will result from a discovery program that is intended to become a larger income discrepancy effort in future years, pending the success of the initial program described in BCP 3.

3. Additional Information Sources to Identify Nonfilers
Resource Need: $1.4 million / 14.1 PYs (17 positions)
Revenue Benefit: FY 2005/06 $10 million increasing to $11 million in FY 2006/07

Beyond existing levels, if this measure is approved, FTB estimates it will use new sources of information to identify an additional 37,000 individuals who fail to file personal income tax returns. FTB's filing enforcement system known as the Integrated Nonfiler Compliance (INC) system was designed to receive, process, match and utilize information from a variety of sources to identify and notify potential non-filers. Consistent with the original INC project objective to periodically add new information sources to the INC database, this measure will add six additional income sources for FY 2005/06. The INC system itself will not be modified to add new functionality.

Although FTB's nonfiler program is recognized as one of the most effective tax compliance programs among state revenue agencies, thousands of nonfilers still escape detection because FTB does not yet have access to some information sources. Taxpayers escape detection when a payer fails to report disbursements and the payee fails to report income. In cases where the payer/payee relationship is personal, the likelihood of accurate information return reporting is decreased. Likewise, where an individual is aware of the absence of an income "paper trail" the likelihood of accurate income reporting is also decreased.

The highest noncompliance levels are those areas where no information reporting requirements exist. Conversely, the lowest levels of noncompliance are those areas where information reporting and withholding exist. Wage earners have a 98% compliance level while compliance levels for individuals with income subject to little information reporting is approximately 70%. Where there is no information reporting compliance levels are only 20%. Equity and fairness of California's tax system provide a strong argument to pursue both wage earners and self-employed nonfilers.

Revenue Estimate

The revenue generated from this measure results from two sources: 1) an increase in voluntary compliance in reporting 1099 income information; 2) additional enforcement actions that FTB will undertake to identify additional nonfilers.

Voluntary compliance revenue. The anticipated increase in voluntary compliance is the result of increased data matching using information returns that report disbursements to real estate brokers and agents. This revenue will be realized starting in FY 2005/06. Initially FTB intended to seek a new 1099 information reporting requirement via a legislative proposal. However, legislation appears not to be required; current law sufficiently defines a 1099 reporting requirement for these disbursements. FTB will undertake a targeted education and enforcement campaign to obtain the required broker income information. The campaign is anticipated to result in higher rates of voluntary reporting of such income.

Estimated Voluntary Compliance Revenue
FY 2005/06 through FY 2010/11 - $10 million per year

Enforcement-based revenue. Separate from the revenue attributable to increased voluntary compliance for 1099 real estate commissions, FTB will collect new revenue resulting from increased enforcement activities using new information sources to identify nonfilers. For FY 2005/06 FTB does not expect to collect any enforcement-based revenue due to "ramp up" time needed to obtain, cleanse and begin using the information to identify nonfilers who will file and pay beginning in FY 2006/07.

Annual Enforcement Revenue (all sources)
FY 2005/06 - $0
FY 2006/07 - $1 million
FY 2007/08 - $3.2 million
FY 2008/09 - $5.9 million
FY 2009/10 - $7 million
FY 2010/11 - $7.3 million

Note that filing enforcement revenue is realized over a four to five year cycle. As the chart shown above indicates, revenue for new cases identified in FY 2005/06 will begin flowing to FTB in FY 2006/07 and increase annually through FY 2010/11. Calculations for each source shown below reflect this multi-year cycle for new cases, i.e. revenue for these cases is fully realized at the end of cycle in FY 2010/11.

Board of Equalization: Motor fuel information for self-employed truckers

This information source will allow us to identify self-employed truckers not filing state tax returns. Statistics from BOE show that 34,000 individuals and businesses pay a diesel fuel fee annually. Applying the typical self-employed non-filer rate of 4.9% X 34,000 = 1,666 potential non-filer contacts. Each contact is estimated to generate at least $201 in revenue 1,666 x $201 = $334,866 (rounded upward to $500,000 for FY 2010/11).

Department of Social Services: Community Care Licensing Information

This information source will allow us to identify self-employed individuals licensed to provide care facilities but not filing state tax returns. DSS licenses more than 88,000 care facilities for children, adults and the elderly. Applying the typical self-employed non-filer rate of 4.9% X 88,000 = 4,312 contacts X $201 = $866,712 annual revenue (rounded to nearest million).

Alcoholic Beverage Control (ABC): Sales information indicating taxable income

This information source will allow us to identify self-employed individuals licensed to sell alcoholic beverages but not filing state tax returns. We estimated revenue using 1999 data provided by ABC. In 1999 there were 72,828 records available. Applying the non-filer contact rate of 4.9% X 72,828 records = 3,569 cases X $201 = $717,369 (rounded to nearest million).

City Business Tax Information: Information indicating economic activity

This information source will allow us to identify self-employed individuals licensed through their city but not filing state tax returns. During FYs 1997 through 1999 California law required that each city that maintains a computerized record keeping system or that has access to such a system and that assesses a business license tax or fee furnish annually to FTB a list of all businesses subject to tax in the preceding year. In 1999, 14,287 filing enforcement contacts were made to taxpayers, yielding an average of $89 in new money per contact. Not accounting for inflation or business growth since 1999, we applied the old $89 per contact X 14,287 cases = $1,271,543 in revenue (rounded to $1.3 million).

Background - The 1983 Revenue and Taxation Code Section 19557 authorized a state mandated city business tax (CBT) reporting requirement for all cities that assess a business tax and maintain computerized record-keeping systems. In 1999, the statute was repealed. Reimbursement costs had skyrocketed and there was little or no accountability of why funds were being paid.

FTB was asked to conduct a more fiscally responsible, non-mandated CBT pilot. Finance funded the pilot with approximately $1,000,000 payable to cities for use of their data based roughly on a $1: $5 cost-to-benefit ratio and 13 cities were invited to participate. The results from the CBT Pilot for the 1999 tax year were disappointing and generated less revenue than expected. As a result, only a portion of the $1,000,000 was paid out based on the cost/benefit formula.

Although the pilot was originally scheduled for two years, the CBT Pilot was discontinued after one year due to budget concerns and directions to discontinue non-mission critical contracts provided under the Executive Order D-49-01. Today, through our INC System, we have a more efficient data matching process that will better utilize the CBT information. We will be able to match more cases per dollar cost. Additionally, cities have indicated their desire to participate in this process at a reduced cost.

Check cashing and similar businesses: Information indicating economic activity

This information source will identify self-employed individuals working in the underground economy and employees being paid under the table. There are no reporting requirements for check cashing and other businesses that cater to individuals and business entities that choose to avoid banks and other financial institutions that must report on customer payments. These taxpayers may be part of the cash-pay or "underground economy" problem, or may engage in illegal activities to derive income. Requiring check-cashing business to disclose information to FTB on customer transactions in excess of $10,000 is consistent with other statutes that require the filing of "cash transaction reports" by businesses for payments made in cash by a customer spending $10,000 or more to purchase a car or other item. This high-dollar threshold will minimize the burden placed on check cashing and other businesses, but will help identify tax return nonfilers who otherwise would not be detected using current methods. Legislation is required for this proposal.

Since statistical information is not available on this source, we used BOE self-employed information. In 2000 we contacted 11,222 taxpayers using BOE self-employed information. Taxpayer contacts of 11,222 x $201 (self-employed new revenue rate) = $2,255,622 new money per year (rounded to $2.3 million).

Use 1099 real estate broker information – Real estate commissions

The enforcement revenue for 1099 broker information results from use of information to identify real estate brokers and agents whose income is not currently being reported on 1099s. To estimate the enforcement-generated revenue attributable to real estate commission reporting, FTB's INC system currently receives approximately 500,000 1099S records annually. We used this as our basis to determine how many "new" 1099 records we may receive as a result of this initiative. Applying the 1099 non-filer rate of .4407% yields 2,204 potential nonfiler contacts. We used the per case revenue yield of $604 to calculate total enforcement revenue of $1,331,216 (rounded to $1.3 million).

Additional information re: voluntary compliance revenue estimate

As indicated earlier, the increase in voluntary compliance attributable to the use of this new information results from increased reporting of real estate commission income. FTB's Economic and Statistical Research staff estimated that voluntary tax compliance and current enforcement-related compliance programs capture approximately 86% of all income tax revenue owed to the State of California and that the remaining 14% of uncollected revenue falls into the $6.5 billion income tax gap. Revenue attributed to an increase in voluntary compliance as a result of using the broker information is estimated to be at least $10 million. Whether this information flows to FTB as a result of a new requirement or whether it flows because more brokers will be notified there is currently a requirement to provide such information, FTB anticipates an increase in new information available for compliance purposes. The revenue associated with this increase in voluntary compliance has been computed as follows:

1. Estimate total resale home sale receipts by multiplying number of sales by median price.
2. Apply an assumed average commission (sum of sales and purchase sides of transaction) of five percent. Although the mean price is higher than the median price, most very high priced residential real estate transactions will produce lower than the typical six percent commission. Thus, the assumption of a five percent across-the-board commission will offset the understatement of the price.
3. For purposes of estimating voluntary compliance, ignore new home sales and commercial sales, because for those transactions a 1099 report generally is already required.
4. Assume conservatively that on only 10% of the transactions would the “new” 1099 reporting provision likely lead to greater compliance. The majority of home sales are handled by real estate agents who work for large brokers.
5. For purposes of estimating voluntary compliance, assume that an escrow agent will disburse the commission check to the broker of record, who will then send the agents' portion to the agent. In these cases the broker must send a 1099 report to the agent (who works as an independent contractor) for the fees submitted. Also assume that for these cases compliance (at least in the reporting of income) is already fairly high.
6. The real compliance benefit of this proposal will be on the independent brokers or brokers with just a few agents working for them. Based on contact with the IRS National Office of Research, we have assumed that income-reporting compliance would jump 15% for this portion of commissions, from 70% to 85%.
7. Assume that 10% of the increase in income reporting would be offset by an increase in deductions claimed.
8. Assume that the revenue impact would grow by 15% from the 2003 base year.
9. To further conservatively estimate revenue, reduce the estimate by $1 million to account for revenue FTB already obtains from noncompliant realtors through our current filing enforcement program.

<u>System Impacts for Additional Information Sources to Identify Nonfilers</u>
The INC application is designed to accept and use new income sources. INC will capture new additional information needed to identify the targeted nonfilers. Only minor changes would need to be made, similar to those needed during the yearly annual change process. No additional software or hardware is needed to implement the new sources. The cost associated with the system changes has to do with the additional system IT staff (3 PYs, limited term) one additional tester, one additional analyst, and one additional developer.

4. Informant Reward Program
Resource Need: $292,000 / 2.8 PYs (3 positions)
Revenue Benefit: FY 2005/06 $0.8 million and $1.2 million beginning in FY 2006/07

BCP 3 includes a proposal to initiate an informant reward program to help combat illegal tax evasion. The program will provide an additional method for the FTB to find tax evaders that our audit and investigation programs normally miss. We estimate that in addition to catching hard-core illegal tax invaders, the program will also annually generate $1.5 million at a cost of $292,000.

Recently, concerns have increased that various forms of illegal tax evasion are widening the tax gap. An informant reward program will provide a means by which concerned citizens may receive a reward for bringing alleged violations of tax laws by taxpayers to the attention of the tax agency.

FTB will pattern its operation of the program after a similar IRS program. According to a 1999 IRS report on its program, the program allows the IRS to cost effectively find tax evaders that would otherwise go undetected. The program pays informants a percentage, not to exceed 10% of tax, penalties and fees (but not interest) collected. The IRS bases the percentage on the value of the information to recover the evaded tax.

Personal services costs to operate this new program include receiving and documenting tips from informants, screening the tips for revenue potential and conducting audits or other activities to determine if tax evasion actually occurred and for what amount.

FTB anticipates that it will conduct only a small number of audits (approximately 50) and other enforcement activities per year, because we need only pursue tips regarding tax issues that are relevant to California law only. This is because we assume that most informants looking for a reward will provide tips to both the IRS and FTB (or to the IRS alone) because the higher federal tax rate will lead to higher rewards. Under an arrangement with the IRS, FTB currently receives information on all assessments the IRS issues to California taxpayers. FTB subsequently issues assessments for California taxes based on the federal audits. Therefore, FTB would need to conduct audits only on those tips that solely involve California law violations, or that FTB judges to have potential even though the IRS chooses not to investigate. FTB would not pay rewards on cases that the IRS informs us about.

The Revenue and Taxation Code (R&TC) has authorized FTB to conduct an informant reward program since 1993. Legislation is required to unambiguously identify that FTB has the sole discretion to determine the amount of each reward paid to an informant. Also, the existing statute does not provide a mechanism for FTB to actually pay informants. The proposed legislation will provide for payments to be issued from collections of recovered tax.

Revenue estimate
Informant Cases

	Returns Adjusted	Adj/Return	Potential Revenue	Discounted for Cash
PIT	32	$27,104	$867,328	$433,664
Corp	15	17,111	256,665	128,333
*Appt.	3	131,070	393,210	196,605
				$758,602

***Apportionment Audits**

5. Underground Economy Criminal Investigation
Resource Need: $1.9 million / 18.0 PYs (19 positions)
Revenue Benefit: FY 2005/06 $1.2 million increasing to $4 million in FY 2006/07

FTB's Investigation Bureau includes a pilot cash-pay/underground economy investigations unit that has identified more than $300 million in unreported income. Investigations staff expects to assess tax on this unreported income in an amount to exceed $45 million. Although this effort is noteworthy, the current inventory of open criminal tax investigation cases exceeds the capacity of the Investigations Bureau to work additional cases. BCP 3 proposes to augment staff in Investigations to accelerate the existing criminal tax investigation cases as well as pursue a significant number of additional cases.

FTB's investigative activities are carried out primarily to protect the tax base by deterring taxpayers from cheating. These activities also increase the tax base by bringing those that are cheating back into the system. This is accomplished through direct investigation and prosecution of specific cases and by vigorous publicity designed to change the behavior of many other taxpayers who become aware of the consequences of cheating but who will not face prosecution. These individuals voluntarily come back into compliance for fear of criminal prosecution. The direct assessment of tax, penalty and interest is considered a by-product of the primary goal.

Recent History of Investigations Program Augmentation and Results

In July 2000 FTB was granted six limited term positions to investigate the cash-pay/underground economy cases. The FTB cash-pay/underground economy pilot program was established in FY 2000/01 to pursue individuals and businesses that flagrantly violate tax laws and significantly impact legitimate business groups in a negative way. FTB currently investigates the most egregious individuals and businesses who fail to file returns or those who intentionally under-report their income.

Mandatory state training for employees working in peace officer classifications, as well as FTB in-house training, required an 18-month training period prior to investigators being fully prepared to work independently and actively pursue cash-pay/underground economy investigations. This training is required due to the complexity of the investigations. In FY 2001/02 the new staff hired 18 months prior, closed their first six investigation cases in this pilot program. Two of cases were prosecuted with underreported income of $18.1 million and a tax assessment of $1.8 million. As of March 2004, the accumulated result for these cases has been 10 closed cases with $44.2 million in unreported income and $6.8 million in General Fund assessments.

Currently, the Investigations Bureau has 70 underground economy criminal tax investigation cases open. As indicated earlier, these cases disclose more than $300 million (and potentially as high as $610 million) in unreported income, and an estimated $45 million in assessments (potentially increasing to more than $91 million).

The cash-pay/underground economy cases being pursued represent all industries and economic sectors. Businesses investigated to date include, but have not been limited to, the construction industry, phone card sales, grocery stores, farming operations, photo labs and service companies. The individuals under investigation are found to live lavish life styles with million dollar homes and expensive automobiles, airplanes, boats and other high end assets, yet have not paid taxes in years. FTB has located these individuals using numerous information items including Suspicious Activity Reports (SARs). SARs became a new source of information provided by the U.S. Department of Treasury for specific and exclusive use of law enforcement officials as a result of the Banking Secrecy Act (BSA) amendments of 1986. U.S. Department of Treasury identified the problem of money laundering and noted the non-compliance with the BSA was widespread and needed to be contained.

The information leads gained from using SARs have proven to be an invaluable tool for the success of the pilot cash-pay/underground economy program. Investigations managers within FTB believe that more use of SARs information can significantly reduce the tax gap. California SARs filings have grown steadily since 1996. In calendar year 2002, SARs filings increased 16.5% over 2001. The volume of SARs in California was approximately one fourth of the total U.S. volume. Based on the California Department of Justice reports, 48% of the SAR's reports filed were due to possible money laundering or structuring activities.

The Public Affairs Program serves to inform and educate the public about the consequences of tax cheating. Absent a strong media presence, the deterrent effect is greatly diminished since court records alone do little to create a general awareness. The success of our voluntary compliance tax system depends heavily upon the public's belief that it is fair and equitable and that cheaters are held accountable.

The additional resources proposed by BCP 3 will enable the Investigations Bureau to implement new efficiencies to work the existing 70 criminal tax investigation cases and provide the capacity to work a significant number of new cases projected to identify $500 to $786 million in unreported income and an estimated $75 to $118 million in assessments over a period of years. The amount of assessments (15% of income) was based on a sample of 10 FY 2003/04 cases on the amount of tax assessed on the unreported income uncovered.

The collection percentage is an estimate of the amount to be collected on these newer, fresher cases. In FY 2003/04, we collected about $800,000 in total on investigations cases. The percentage is lower than we estimate from future cases, because it was calculated based on older unproductive cases. The newer, fresher cases should be more productive, percentage-wise. We are projecting $1.2 million for FY 2005/06 increasing in later years as staff are trained and become more experienced.

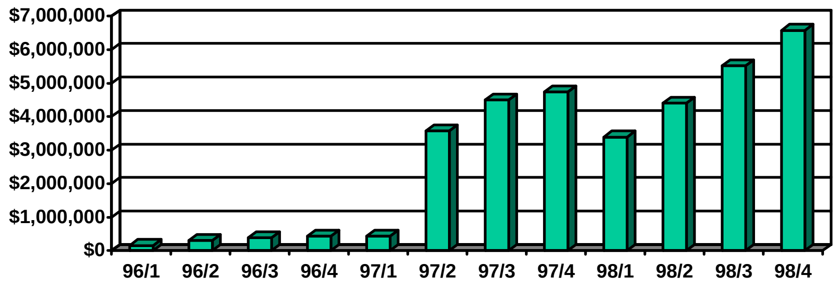
Cost Benefit Considerations

Investigation cases often fall outside the normal tax collection or audit funding criteria and typically address the most egregious violations of the California Revenue and Taxation Code. The long-term deterrent effect of investigations exceeds the immediate revenue benefits that can be cited.

Deterrent measures also are difficult to measure in terms of producing self-assessed revenue. However, the deterrent effect of enforcement actions is demonstrated by the following case study.

Case Study: Construction Industry in the Sacramento, El Dorado & Placer Counties

This construction industry case involved employment tax (EDD) fraud and income tax (FTB) fraud. The case was first looked at by EDD in early 1997 when reported payroll from 21 construction companies operating in Sacramento, El Dorado and Placer counties was in excess of $400,000. FTB was asked to participate a few months thereafter. Covert surveillance by special agents revealed that the majority of the payrolls were being transacted under-the-table in a cash-pay, economy. In the span of one quarter, as word spread through the community through FTB's publicity efforts, reported payrolls for the same 21 construction companies increased more than 800% to over $3.5 million. The subsequent quarters reported over a ten-fold increase in voluntary payroll reporting. The graph below illustrates the deterrent effect.



During interviews of the suspects operating the cash-pay scheme, they said that FTB's investigation effectively shut down cash-pay operations in the three counties. They also indicated that the only way the government will stop cash-pay operations and the underground economy is to criminally investigate such operations. They said that civil actions tend to be viewed as the cost of doing business.

This case illustrates that tax enforcement efforts do deter noncompliance and lead to higher rates of voluntarily reported revenue. It also shows that tax agencies are able to measure the rate of change in voluntary compliance over a period of years for specific enforcement programs, based on taxpayer behavior in areas such as accuracy in filing, delinquent filing and payment rates, etc. While FTB believes the tax gap measures proposed by BCP 3 will result in positive behavioral changes on the part of taxpayers, the department does not currently account for revenue in a manner that shows such changes will shift significant revenue from the enforcement category to the "self-assessment" or voluntary category. However, as indicated earlier, for every one percent increase in compliance that results from undertaking new tax gap enforcement measures, about $500 million in revenue will be captured that otherwise would be lost as part of the tax gap.

Another example of the deterrent effect occurred when an analysis of tax liability reported on a business undergoing an investigation showed that for returns filed in the four years prior to a search warrant in December 1999 (for years 1995-1998), the tax liability averaged $203 per year. Since 1999, the tax liability reported for the same company for years 1999-2002 averaged $31,700 per year.

C. State Level Considerations

Voluntary Compliance and Deterrence: Closely tied to this proposal is an education and publicity element. Informing the public of these new provisions through the media will help the individual proposals have a much broader impact on taxpayer behavior and the tax base than the result of a single enforcement action on an individual taxpayer. The emphasis placed upon these provisions through publicity and education will encourage future self-compliance by taxpayers who are currently circumventing their tax obligation, deter others who are considering noncompliance, and reassure compliant taxpayers that pay their fair share.

These proposals are directed to noncompliant taxpayers. Taking action to begin closing the tax gap results in more equitable taxation for those taxpayers who voluntarily comply with the State's tax laws.

These proposals place few new burdens on businesses. Nevertheless, there are a few noteworthy impacts to check cashing businesses and escrow/title companies that pay real estate commissions if legislation is required for a new 1099 information reporting requirement.

D. Facility/Capital Outlay Considerations

This BCP includes facility funding in the amount of $312 per position. The standard dollar figure was derived using the actual average cost per position of the facility costs. This standard cost will be sufficient to provide for the on-going facility cost for the positions requested.

E. Justification

This proposal attacks segments of the tax gap in a comprehensive manner by increasing enforcement of existing statutes, by undertaking new deterrent measures and by creating public awareness of the consequences of tax-related cheating. This proposal generates immediate revenue for the state and increases the tax base in the long term through increased voluntary compliance on the parts of individual and business entity taxpayers.

F. Analysis of all feasible alternatives

Alternative 1: Provide funding $8.615 million and 99.2 PYs (106.5 positions) to fund the tax gap enforcement proposals and increase the number of enforcement resources for this effort.

This alternative takes a holistic approach and attacks the tax gap in a comprehensive manner by increasing enforcement of existing statutes, by undertaking new deterrent measures and by creating public awareness of the consequences of tax-related cheating.

This approach increases immediate revenue by $34 million through enforcement actions or by stopping refund claims. The total projected revenue for the enforcement effort will be increased to $46 million in FY 2007/08. These measures will also cause taxpayer behavioral changes in favor of self-compliance over the long term. As a result, the state's tax base will increase.

Alternative 2: Provide no additional funding to work the enforcement proposals.

Do not provide additional resources. The department will continue to operate with the current level of resources and address their workloads as they have done in the past.

Alternative 3: Provide funding for some of the enforcement proposals.

This will decrease revenue from that provided in Alternative 1. This will also decrease the deterrent effect of these enforcement provisions.

G. Timetable

Staff can be hired and begin training in July 2005. Enforcement activities will begin after the conclusion of the training activities.

H. Recommendations

To achieve the desired objective of increasing revenue for the General Fund, and encouraging self-compliance, the department recommends Alternative 1. This proposal would:

- Provide an increased enforcement presence that discourages non-compliance and protects the current and future tax base.
- Help to provide assurance to self-compliant taxpayers that California is taking steps to close the tax gap.
- Generate additional tax revenues needed to fund state operations.

If we do not take immediate steps to address California's rising tax gap, we will see it continue to grow as evidenced by the 300% growth from the 1980's to the tax gap of over $6.5 billion today. Compliant businesses will increasingly be at a disadvantage when competing for business against their noncompliant competitors. In our voluntary tax system, most taxpayers comply because it is the right thing to do. Unfortunately, some taxpayers comply only because they believe they will get caught if they do not. At it's meeting on August 25, 2004, the Franchise Tax Board approved this BCP.